

UNIVERSITY OF CAPE TOWN SCHOOL OF ECONOMICS

**SHOULD SOUTH AFRICAN AIRWAYS BE PRIVATISED GIVEN THE
AVIATION DEREGULATION POLICY IN SOUTH AFRICA?**

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ABSTRACT

This research consists of a wide literature review on deregulation and privatisation of airline business world wide. The emphasis is on the benefits of airline privatisation. The idea was to attempt to find out whether the deregulation of South African Airways (SAA) indeed brought about the changes that are expected of a commercial concern. These changes included cost cutting strategies and charging economically efficient fares as well as abandoning unprofitable routes.

Some personal contact with the SAA Public Relations Officers in Cape Town and Johannesburg was used to gather the data used in the research. The Transnet and the Competition Board annual reports were other major sources of data. The analysis was accomplished by scrutinising the SAA financial statements as to whether SAA followed all the requirements implemented when deregulation was introduced. An econometric test was used to check whether there was any improvement in capacity utilisation at SAA as was expected to happen after deregulation.

The findings from this research are that SAA did introduce new measures to try to be profitable and cut costs, such as, reducing the labour force and abandoning unprofitable routes. SAA also stopped cross-subsidisation practise, whereby loss making routes were financed by profitable ones. In general SAA introduced measures that can be expected from a profit maximising firm which is under pressure to turn profits. However, these changes have not yet produced consistent results as far as profit is concerned and is supported by the econometrics test which does not support the expected hypothesis that since SAA is now operated on commercial basis, should be able to turn profits and be efficient.

Although profit alone might not be an efficient measure of the performance of SAA given that airline business is highly dependent on the economic cycle, there is an element of hindrance to the general performance of SAA in the continued association of SAA and Transnet. This association does not give SAA much leeway to structure its balance sheet the way it wants it or deems more profitable. Thus, it could be said that, there is an

INTRODUCTION

Privatisation has become a central feature of the economic policies of a variety of nations regardless of whether they are developed or developing. The private sector is sought after for its disciplines in corporate governance, which is seen to be a catalyst for economic growth. Privatisation embraces denationalisation or selling of state owned assets, deregulation or liberalisation and competitive tendering as well as the introduction of private ownership and market arrangements where they do not exist.

Privatisation policy is normally associated with various objectives, some of which are in conflict. In all the cases, consumers are expected to benefit from the introduction of market forces reflected in the profit motive, rivalry, more choice, greater efficiency and innovation. In certain cases, the policy aims to reduce both the size of the public sector through denationalisation and public sector borrowing. A conflict might arise when the selling of the public asset is not compatible with the goal of efficiency, such as transferring monopoly power from the state to the private sector with out increasing competition and rivalry.

The privatisation debate in South Africa has been an ongoing affair, and it intensified after the election of the new government in 1994. This was in some part attributed to the need to restructure the public sector and at the same time redistribute wealth to the previously disadvantaged South Africans. It was realised that there were too many regulatory limitations on economic activities in South Africa, and for job creation and growth of the economy the private sector had a key role to play in the economy as a whole.

Thus the purpose of this paper is to make a contextual analysis of the above with South African Airways (SAA). The main aim is to determine whether SAA was indeed inefficient before deregulation and whether its operations improved after deregulation. The motive for this is to determine whether SAA has restructured enough to privatise. It should be noted that state-owned firms should be restructured before sale by introducing reforms that are reasonably feasible and that enhance efficiency and profitability. This will make the value of the firm more visible to the

private sector and also raise the bargaining power of the seller as it will be easier to hold out for a higher price when a firm is commercially viable. This point is important because for the state to gain support on privatisation from the public, it should not be seen to be disposing off state assets at give away prices.

The biggest constraint in the research has been the lack of adequate and relevant data available on SAA. The problem is that since SAA belongs to the Transnet group, it does not prepare or compile its own statistical data which would have made matters easier in this research. The difficult task of using the Transnet annual reports is that they only report consolidated results of the group. This made the analysis complex, in that, it was not possible to make a separate analysis of international, regional or domestic operations of SAA. Thus, the arguments here might be a little biased towards domestic operations, since the authorities have more power to influence changes domestically as opposed to regionally and internationally.

The research methodology used in this paper has been such that the arguments presented, are a result of an extensive literature review on the deregulation and privatisation of airline industries world-wide. Personal, E-mail and telephonic contacts have been made with the relevant people at SAA.

The paper has been structured as follows: Chapter one discusses a general overview of how the state became involved in the provision of goods and services, and also the short comings of the state's involvement in the market. This chapter also argues for the introduction of a market economy and that is where the benefits of privatisation comes in. Privatisation is advocated to be the best solution to problems of government failure and inefficiency.

Chapter two focuses on the economics of airline industries. This basically puts into perspective the complexity with which airline operations are involved. The historical background of aviation in South Africa is also discussed in this chapter.

Chapter three discusses the performance of SAA before and after deregulation. An effort is made to try to compare SAA's profitability before deregulation and after deregulation. This is done by looking at the improvements SAA engaged in after

deregulation which were intended to improve its efficiency and profits as well as the strategies it used before deregulation which could be said were not profit oriented. Some reference is also made in this chapter to deregulation of airline industries elsewhere as a yard stick to find out whether SAA is on the right track.

Chapter four is a mini one which tries to determine whether indeed what is expected of deregulation was achieved, such as cost reduction and improvement in capacity utilisation. An econometrics test was employed to test whether there was an improvement in capacity utilisation.

Chapter five discusses the recommendations based on what transpired in chapters three and four. The bottom line is that SAA has restructured enough and the recommendation is that it is ready to be privatised. Commercialisation alone is not suitable because the involvement of the state in the operations of SAA would make the competition field uneven (free market forces would be hindered). The gradual approach of strategic partnership is the method recommended for SAA's privatisation because of its advantages given the complexity of airline business. Chapter six gives the conclusion and summary of the whole paper.

CHAPTER ONE

1.0 From Plan to Market

The current era is of tight government budgets and popular discontent with public services. These make governments all over the world look to the private sector for ideas about how to manage government organisations for greater efficiency and effectiveness (Goldsmith, 1997). In some cases the government solicits ideas from the private sector (commercialisation), while in others it sells state owned enterprises to the private sector either as a whole or partly.

Privatisation therefore becomes the relegation of the provision of public goods to the private sector. It is a move from a centrally planned economy to a market economy. Different countries have undertaken privatisation for various reasons and thus at different speed. The main reason for privatisation which can be said to be universal to both the developed and developing world is that it is intended to diminish or even eliminate the burden of the state owned enterprises on the state's finances by improving economic performance (Deme, 1997). In some countries such as Zambia and Mexico, they had huge public debt which they could not finance any longer. Therefore, they had to adhere to the International Monetary Fund's (IMF) conditions of the structural adjustment programmes for them to be considered for any further financial assistance. These meant that they had to restructure their public sector drastically, by either selling them to the private sector or liquidating non viable ones.

1.2 Role of the State

The centrally planned economy goes back to the days of Karl Marx who believed that socialism was the best system. This stemmed from the believe that if the market is left alone only suboptimal equilibrium will be obtained. Market regulation was therefore seen as a corrective measure in the face of market failure or suboptimal equilibrium. Theodore (1991:39) commented that "*where markets tend to operate with an underdevelopment bias, it is almost axiomatic to say that intervention is necessary*".

On the other hand, the neo-classical theory postulates assumptions of perfect competition and perfect foresight. It is through competition that the equilibrium optimums can be obtained, resulting in a more efficient and improved distribution and allocation of resources. The implication of the neo-classical theory is that all economic agents behave rationally in a bid to maximise their utility or profit. Thus any disturbance in the system will be anticipated well before it occurs, leading to the economy adjusting automatically to a stable equilibrium (Black and Dollery, 1992). Therefore, the neo-classists believe the government should not be involved in the market as the economy can take care of itself (adjust instantaneously and be efficient).

However in the real world people do not have perfect information, they usually operate under conditions of significant uncertainty. This might lead to the emergence of imperfect competition such as monopoly and oligopoly. There are also problems of public goods, externalities and merit goods under which the efficient equilibrium will not be reached. Under these circumstances there is a market failure which calls for government intervention to guide the economy to an efficient equilibrium solution.

The involvement of the government in the market is well documented in public finance works. Musgrave (1989:P17) stated three main reasons for government intervention as,

- the need to ensure an efficient allocation of resources,
- the need to stabilise the path of the economic progress and,
- the need to distribute income and wealth equally.

The government is required to perform the allocation function where the production of public goods is involved, because private enterprise cannot respond adequately in the absence of price signals or when the possibility of making profit is insignificant. The government will also be duty bound under this function to control the production of goods and services whose market prices may not truly reflect their social value, such as education and health care.

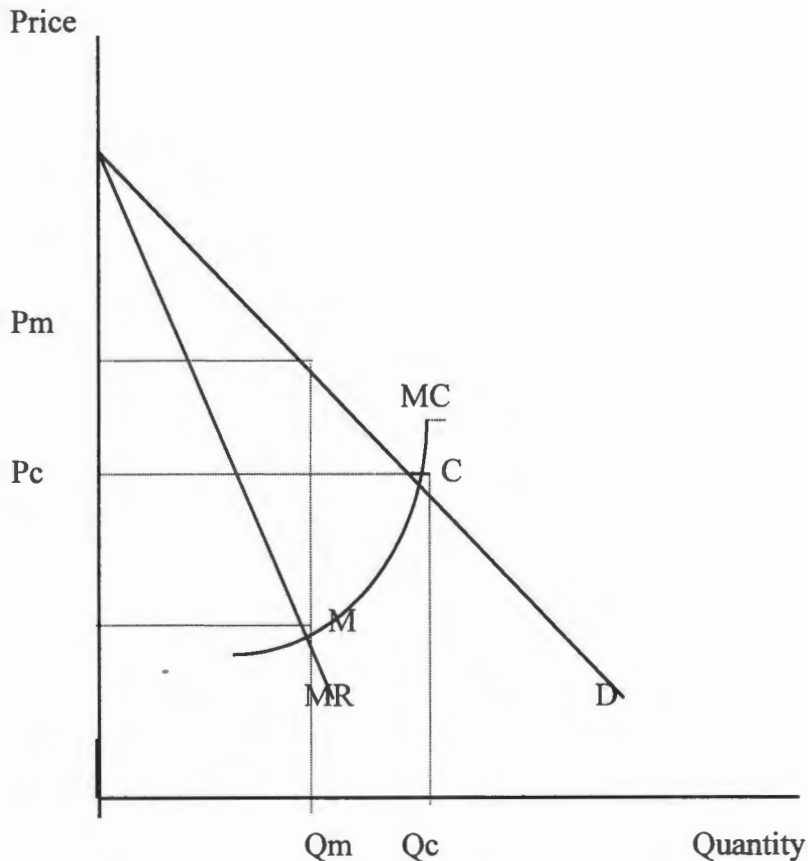
The government is also required to stabilise the economy in terms of curbing inflation

and unemployment. This is directly related to the government's political and social objectives. The market economy can also cause problems related to fiscal and monetary policies, such as high inflation which might be bad for economic growth (lack of investment) and the government needs to redress that.

The government is also needed to enforce a legal structure which will be functional to economic progress and encourage wealth accumulation, especially for the private sector to exist. An example of these will be property rights and contract laws.

Figure 1 below is used to illustrate a market failure under monopoly. It is also worth noting that there are two types of monopoly which are, an artificial monopoly (operating in a market where perfect competition is technically feasible) and a natural monopoly which is technically not feasible to operate under perfect competition conditions. This is the case because the nature of the service provided does not allow space for competition or even if it does, one firm will find it impossible to continue the business due to losses it makes. Figure 1 only illustrates the difference between artificial monopoly and perfect competition, while natural monopoly will be handled elsewhere in the paper.

Figure 1



Artificial monopoly may exist as a result of potential competitors being prevented from entering the market either by the government or the concerned firm's behaviour of setting price below its profit maximising level to prevent new firms from entering (Black and Dollery 1992).

Under perfect competition, equilibrium occurs where the sum of the individual marginal cost curves (MC) are equal to market demand (D) for the commodity. This is given by point C in Figure 1. The corresponding price and quantity demanded are P_c and Q_c respectively. In a monopolistic situation or market supplied by one firm only, the firm maximises its profit when its marginal cost equals marginal revenue (MR). If we assume the monopoly firm to have the same marginal cost and demand (same MC and D curves) as our competitive firm, then its profit maximisation point will be at M in Figure 1. The equilibrium price and quantity demanded will be P_m and Q_m respectively. This reveals that a perfectly competitive industry will provide more

goods ($Q_c - Q_m$) at a lower price ($P_c - P_m$), while the monopolist provide fewer units of the good at a higher price. Thus the state intervention is justified in this case to try to provide more goods at a reasonable price.

As mentioned earlier the government may also be needed to intervene in a situation of externalities. Externalities refers to the condition whereby the production of goods by one firm and consumption by one individual leads to others benefiting or suffering. An example of others suffering may be in the case of copper production, whereby the company benefits from profits while the society suffers from the sulphur dioxide emitted into the atmosphere. On the other hand an example of the society benefiting can be when an individual is inoculated against chicken-pox. Members benefit individually from this but the rest of the society also benefits indirectly from the disease not spreading to them. So the government is needed to force the copper producing firm to be responsible for the pollution it causes for the sake of the well being of the society as well as ensuring that the chicken-pox vaccine is available even though it is a rare disease.

Figure 2 below is used to illustrate an externality situation where society stands to benefit, such as health.

The graph illustrates the relationship between Price and Quantity for a firm. The vertical axis is Price, and the horizontal axis is Quantity. The graph includes several curves: Marginal Product of Capital (MPC), Marginal Social Cost (MSC), Average Product of Capital (APC), Marginal Revenue (MR), and Marginal Social Benefit (MSB). The demand curve is labeled MPB=D. Key points are marked: M (intersection of MR and MPC), S (intersection of MSC and APC), T (intersection of MSC and MSB), and G (intersection of MR and MSB). Dashed lines indicate the corresponding price and quantity for each point. P1 and P2 are marked on the Price axis, and Q1 and Q2 are marked on the Quantity axis.

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to increase output to the social optimum level, rendering its involvement in the market.

Another notion of externality that could compel the state to be involved in the provision of a service is when consumers lack information about the existence of the same service elsewhere at a cheaper price. This could be due to budget constraints which confines the consumers to the little information they have. Therefore, the consumers end up only at a suboptimum equilibrium. In this case the state needs to centralise the information network so as to help consumers to easily obtain information about the existence of various services, and thus they can attain optimum equilibrium. Externality problems can also exist when the private sector is reluctant to venture into the provision of goods and services due to risk involved or not being aware of the pecuniary internal and external economies of scale, such as the airline business. Therefore, the state is needed to take up the provision of such goods and services until the private sector is comfortable to take the provision.

1.3 Why Privatiser?

Although the government's role in the market might seem solid and genuine, there is also a problem of government failure in its bid to correct the market failure. This stems mainly from the principal-agent relationship under state-owned enterprises as compared to their private counterparts. State-owned enterprises usually tend to have multiple objectives as opposed to the single one of profit maximisation allegedly pursued by their private counterparts. An example here is that the state-owned enterprise's objective may include profitability while on the other hand they have to meet social objectives in terms of charging lower prices, and reducing unemployment. Therefore, state-owned enterprises are unnecessarily large and uncompetitive, as well as not being sensitive to the wants of the consumers.

State-owned enterprises are also perceived to be inefficient due to direct competition from private firms often being excluded. Their funding is usually through the government budget, and they can use the government as a guarantee when they have to acquire loans from outside the government (or country). The result is that the state-

owned enterprises may have no bankruptcy constraint if government is always bailing them out. This in turn leads to the government's borrowing requirements bulging to unmanageable levels at times. These usually leads to adverse effects of high deficits and taxes.

Another point of nationalisation was to facilitate cross-subsidies from more profitable services. The motive for this is that cross-subsidisation of uneconomic services keeps alive the possibility of choice for some economically depressed areas. The end result is that cross-subsidisation entails restrictions on competition so as to protect the source of funds. However, this is merely a transfer payment unrelated to any welfare payment considerations and it distorts the allocation of resources and strengthens the need for some form of state enforced monopoly

The bottom line is that, state-owned enterprises operate under different constraints to their private counterparts. They suffer from too much bureaucratic red tape problems, lack of accountability, and lack the incentive to innovate or venture into new technologies to improve production, which lead to sub optimum results being achieved.

Privatisation seems to be the remedy for the above problems. As already mentioned privatisation entails ownership change and hence incentive and constraints adjustments. The market economy relies upon the process of exchange and provides the necessary opportunities to entrepreneurs. When there is no intervention or individuals are allowed to exchange freely, economic development occurs to the benefit of all the participants in that economy. Thus privatisation if well done will ensure that goods produced are placed on the market at a fair price.

It should be emphasised that privatisation should go hand in hand with competitive conditions being available in the market to ensure the incentives and constraints do change. Competition makes sure that optimum equilibrium is obtained and thus a more efficient and even distribution and allocation of resources and diffusion of power. Under competitive conditions, discipline is very high as the quality of management decisions are continuously tested in the market place for goods, labour and capital. Private shareholders who provide capital are usually keen to see excellent

performance in terms of results. These help contain the self-interested behaviour of the managers since they stand to lose their jobs if they do not perform. This will also compel managers to charge prices that maximise the value of the firm's assets.

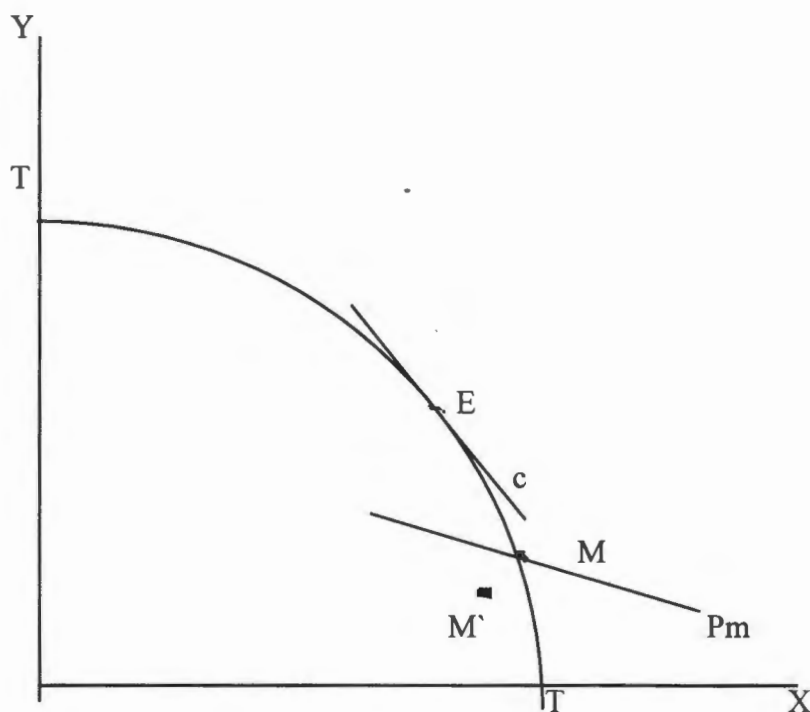
The threat of bankruptcy in a competitive and private environment ensures that only the fit survive. Here profit motive makes for team work within the organisation and between institutions imperative, and this usually leads to an efficiency-oriented management. For example, management effort will be directed to choosing output which yields the biggest margin of revenue over the costs incurred.

The market mechanism brings about adjustments of demand and supply, it provides innovation and permits the adaptation by firms to new needs and conditions timeously. Again due to its decentralised process, the market mechanism might help to disperse economic power, decision-making responsibility and initiative.

Privatisation will also increase the tax-base as enterprises sold will now be subjected to profit tax. The proceeds realised from the sales as well as the tax could be used for various things, such as paying national debt, providing capital funds for small businesses and also for the financing of basic infrastructure. The latter point is justified if it is for better utilisation of resources. An example is the provision of roads for the private sector to perform efficiently. Funds could also be used to finance tax cuts, which will deter capital flight and strengthen work efforts and investment. These would in a broader sense lead to economic growth and greater social welfare.

Figure 3 below is used to illustrate inefficiency that might arise from the presence of monopoly (especially that of state owned enterprise) as compared to a competitive firm.

Figure 3



Assuming a hypothetical economy in which two goods (sector X and sector Y) are produced under perfect competition conditions. From Figure 3 the line TT is a production possibility frontier (PPF) indicating various combinations of goods and services (X and Y) which could be produced by fully utilising the economy's productive resources. The slope of the PPF represents marginal rate of production transformation ($MRPT_{x,y}$) between the two sectors. Thus, under perfect competition, the economy will be operating at point E with optimal resource allocation. The $MRPT_{x,y}$ at point E will be equal to the ratio of the respective prices ($MRPT_{x,y} = P_x/P_y$), represented by the line c tangent to point E. If we now assume that sector Y is a monopoly while sector X maintains perfect competition conditions, then it means the production of good Y will decline but will be sold at a higher price (as was shown in Figure 1). From Figure 3, the monopolist production will be at point M and the commodity price is represented by line P_m which has a gentler slope than at point E indicating a higher price.

Therefore, the difference between the production points of the two commodities (E and M) is a reflection of the degree of allocation inefficiency arising from the presence of monopoly in one of the two sectors (Black and Dollery 1992). This can

also be interpreted to mean that the whole economy is producing too little of good Y relative to X at point M, and there is a potential to move to point E by reallocation of resources in a manner which increased the production of good Y relative to X, for the benefit of the whole society.

There is also another situation of inefficiency associated with monopoly, and it is referred to as X-inefficiency. This can be associated with state owned monopoly. As mentioned before due to lack of threat of competition for state owned enterprises, slackness is very rife and production ends up not being even on the PPF but at a point such as M', inside the PPF in Figure 3. So the economy has failed to achieve the optimal allocation of resources (Black and Dollery 1992)

X-inefficiency may take two forms, pecuniary or real. Under pure pecuniary X-inefficiency, resources owners are simply paid in excess of their opportunity cost. While marginal physical product are the same as in a competitive industry, factor costs are increased, quantities of resources employed are reduced and output is reduced (Thistle and Keeler, 1990). The cost of producing the output is increased by the inflated factor payments. In this case pecuniary X-inefficiency becomes the transfer from owners of the firm to resource suppliers, and is therefore not a social cost. Real x-inefficiency (the form normally associated with Leibenstein) is when resources suppliers are paid their opportunity cost, but being permitted to be less productive than they would be in a competitive industry (point M' in Figure 3). The result is lower marginal product, but remuneration at competitive factor prices implying higher cost and thus a reduction in output. Thus the real X-inefficiency becomes a social cost.

There is however resistance to privatisation. The insiders at state-owned enterprises, oppose privatisation as they fear losing income and power. Privatisation will reduce employment as private owners dismiss redundant workers. Private owners however, will only be practising the concept of marginal equivalency, whereby, it is only beneficial for the firm to employ factors of production, for example labour up to a certain level of output, beyond which any more addition is unprofitable. Under state owned enterprises this concept maybe ignored or overshadowed by the need to provide employment. As a result the state-owned enterprises may end up

overmanning but with lower production. Thus, these cause unwanted inefficiency under state-owned enterprises.

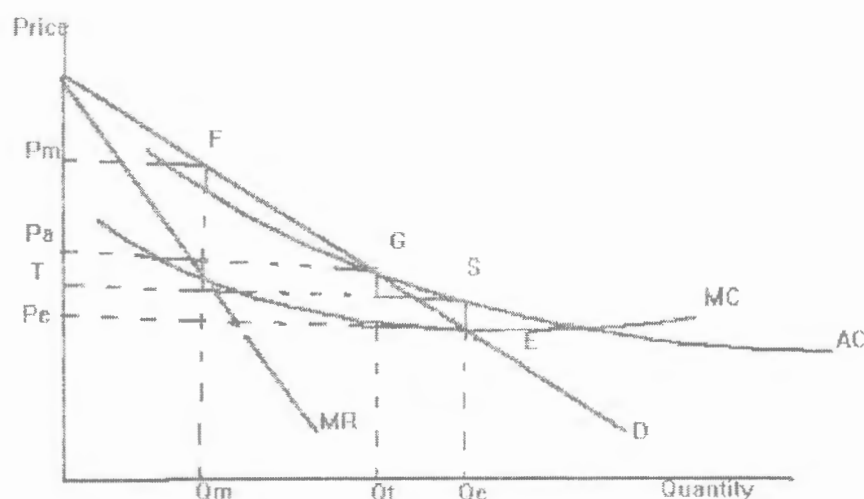
Privatisation is also opposed because it might mean transferring monopoly from the state to private hands. Even though private monopoly will be more efficient than state monopoly due to the ability to innovate and pressure from shareholders to perform, the important thing to consider is to have well established competitive conditions in place before transferring the state-owned enterprise into private hands.

According to Brada (1996), practical difficulties normally compound resistance to privatisation. “ *The valuation of firms is difficult because capital markets barely exist, accounting statements can almost be meaningless, and profit and sales achieved are a poor guide to future viability*” (Brada, 1996;P68). Therefore, suspicions naturally arise that buyers would be benefiting from low prices at the expense of the state.

1.4 Can All State-Owned Enterprises be Privatised?

This brings us to the other type of monopoly, called natural monopoly. It is whereby a large capital outlay gives rise to economies of scale over the entire range of its output. Also the minimum average cost of production might occur at the level of output sufficient to supply the whole market. This makes it possible for only one firm to operate efficiently in such a market. Examples here will be the production of some public utilities such as electricity and water. These industries therefore are normally best left for government as will be illustrated by figure 4 below.

Figure 4



As every industry's survival is based on whether it can recover its costs and make profits, under natural monopoly it means the average cost (AC) diminishes as output increases. Its marginal costs (MC) thus lie below the AC over the entire output range. These can be seen from Figure 4. As already mentioned in the paper, perfectly competitive market conditions for profit maximisation is for each firm to set MC equal to the market price. This is represented by point E in Figure 4, with a price of P_e and quantity Q_e . However, due to the fact that AC is above MC at this point the firm will be making a loss equal to SE. Thus firms which try to be competitive in this case will eventually close down and only one will remain now employing monopolistic conditions (natural monopoly).

Normally a monopolist will maximise profit by equating marginal revenue (MR) and MC, then the price charged will be P_m and quantity Q_m from Figure 4. As before this reveals the unwanted outcome of high price and less quantity of a monopoly. Therefore, the government becomes the sole saviour of the society in this case. Various options can be employed by the state to try to provide the service cheaply and enough quantity for the society. The state, driven by social considerations will be compelled to take over such operations and charge P_e for Q_e units of the service.

However, the loss thereof, will have to be paid for by a subsidy equal to the rectangle TPES in Figure 4. The big question will now be how the government raises funds for the subsidy?.

This brings us to the concept of second-best theory. Whatever action the government takes in raising the funds for the subsidy, for example a tax increase, has to carefully weigh the allocative gains derived from a subsidy against the distortionary effect that a new or higher tax may have on the economy (tax incidence). Naturally the adoption of marginal cost pricing in any one industry will constitute a first-best solution only if there are no distortions elsewhere in the economy, that is, if all other markets are competitive (Black and Dollery 1992). If a new tax to pay for the subsidy introduces a disturbance in the rest of the economy, the first-best solution will become unattainable. Thus the second-best solution entails non-competitive pricing in all markets.

The complementarity and substitutability between various goods and services is a very important phenomenon in the concept of the second-best theory. The second-best theory demands that if a natural monopoly is subsidised by distortionary tax that raises price above marginal cost in another sector of the economy, and the two goods concerned are substitutes, then the natural monopoly should also charge a price above marginal cost so as to avoid an excessive shift in demand towards its own good. If the goods are complements, then the natural monopoly has to make sure that it charges a price below marginal cost to ensure that consumers buy an efficient combination of the two (Black and Dollery 1992).

The bottom line here is that a natural monopoly should remain in the hands of the government so as to regulate them or force them to expand output by setting price close to MC(price somewhere between P_a and T and quantity somewhere between Q_e and Q_t). Thus privatisation should be analysed based on whether a particular enterprise is an artificial monopoly or natural monopoly.

1.5 Empirical Evidence on the Efficiency of the SOE and Privatisation

Privatisation as already mentioned is a policy for both developing and developed countries. The question that then follows is how easy countries are able to perform this task. As Krippner (1997:6) puts it, "*state intervention is sometimes driven out of proportion by recipients of state services who tend to reinterpret benefits as rights*". This is usually supported by the state especially to sustain legitimacy. This therefore makes privatisation policy a difficult task for some countries to implement while it is even easier for others.

According to the World Development Report (1996:9), formal privatisation may be accomplished in one or two years, but changing the fundamental governance of large firms always takes longer. The mammoth task is developing market supporting institutions such as legal and financial systems. This involves change in skills, organisations and attitudes. Another impeding factor can be from the labour force which normally associates privatisation with loss of employment.

However, in some instances the labour force or the masses are very willing to let state-owned enterprises be sold. An example of this is the privatisation of an agro-industrial firm in Mexico (The Mexican Coffee Institute). According to Krippner (1997), the rural population of Mexico had depended on this enterprise for their employment, financing, processing and marketing commodities produced by small holders for many years and one would have expected the government to encounter serious resistance when trying to pull out. The answer to this is that people have become aware of the benefits associated with privatisation. The World Development Report (1996) points out that the empirical evidence comparing public and private enterprises in industrial market economies concludes that private firms exhibit higher productivity and better performance than public enterprises. The same report showed that an analysis of sixty-one privatised companies in six developing and twelve developed countries revealed that at least two-thirds of them, had increased their profits, sales, operating efficiency and capital investment. All these were purported to be "*....with no evidence of falling employment*" (World Development Report, 1996 :49).

According to Deme (1996:88) the 29 Sub-Saharan African Countries listed by the World Bank have eliminated 550 companies from their government portfolio, and from those, Benin, Nigeria, Guinea, Mozambique, Ghana and Senegal represent two-thirds of state withdrawal operations. The table below compares privatisation in Sub-Saharan Africa with those in other less developed countries. It can be seen that the process slowed down as time went on, especially for Sub-Saharan Africa.

Table 1

Number of Privatisation in less developed countries					
	1980-1991		1988-1992		
	No. of Enterprises	%	No. of Enterprises	%	Privatisation Value
Middle East	58	4.3	11	8.9	1133
Asia	122	9.0	29	23.5	8778
Sub/S.Africa	373	27.5	5	4.1	33
Latin America & Caribbean	804	59.2	78	63.4	37270
Total	1357	100	123	100	47124

Figures in millions of Dollars

Source: Deme (1997:89)

Deme (1997), also points to the little influence the selling of public enterprises had on market structures. *"In certain cases they increased industrial and financial concentration into the hands of certain families or groups close to those in power, and as a result public monopolies have been transformed into private monopolies"* (Deme, 1997:89) This basically shows how privatisation if hastily implemented can be a failure. Therefore, the process needs full consultation of all the parties concerned, and a clear picture of how the whole society stands to benefit.

Another study in Hartnett (1997), by Meggison et al, showed that the firms they studied in 18 countries became more efficient after privatisation. Although evidence of restructuring through privatisation differs among countries, there is more evidence to the effect that many state owned enterprises have responded along the lines

expected of firms whose managers are fulfilling the objectives of wealth-maximising owners. According to Brada (1996:80), surveys of firms in countries such as Hungary, Czechoslovakia and Poland revealed that when restructuring or transformation was implemented, managers undertook short-term adjustments in output and input levels that are broadly consistent with what would be expected of profit maximising firms. Output, employment and capacity were reduced to reflect market demand. Managers also attempted to reduce operating costs and exposure to bad debts.

Another motivation for state-owned enterprises to become more efficient might just be a mere possibility of entry. The threat of substituting new firms for existing ones might offer a sufficient spur to make existing producers perform more efficiently. For example, management take-overs could be encouraged for utilities that do not meet service or productivity criteria.

Therefore, the important lesson from the evidence is the importance of competitive conditions and change in regulatory policies, as well as ownership for incentives and efficiency.

CHAPTER TWO

2.0 Economics of Airline / Aviation

It is a known fact that air service like other modes of transportation (rail and road) is a very essential input into the socio-economic life of a country. They can be regarded in loose terms as lubricants of the economy. They are means to an end because they open up new opportunities for production, consumption and external linkages or relationships of a country.

Transportation services besides those of carriers are mainly not an end in themselves. They may be required as a need to fulfil another objective. An example is that, transportation may be needed as part of a business trip, holiday or weekend visit to watch a sports fixture (Doganis, 1993). This therefore, makes transportation services a derived demand in that it is dependent on the demand for these other activities. It also implies that to forecast the demand for air services one must forecast the demand for all these other types of expenditure. The airlines are thus put under pressure when selling themselves to “.. *expand into other areas of travel industry such as hotels, tour organisers and travel agencies in a bid to gain total control over the travel product*” (Doganis, 1993:21). This notion is also in line with the behaviour of airline advertisements which try to interest people in a particular destination or particular type of trip upfront while the costs and the name of the airline seem to come as an after thought.

One important point that must be understood is that the airline products are homogenous in nature. There is little difference between one jet aircraft and another if they achieve similar journey times. A freight forwarder's major decision will be to choose whether to ship by air or surface, and once a decision is made on air conveyance, then which airline to use is taken to be a minor one. The matter here is that airlines end up offering very similar products.

The resultant effects of the homogenous nature of the airline products are that in competitive conditions airlines make costly efforts to try to differentiate their products

element of government failure due to this association. Therefore, it is recommended that SAA has restructured enough to be privatised. The kind of privatisation for this is the strategic partnership because of its gradual approach element. The gradual approach is crucial because it is not likely to cause much resistance from the labour force and safety requirements in airline business is not compromised.

from that of their competitors. This is done by advertising, the first to introduce new aircraft types as well as increasing frequency of service. Doganis (1993:21), highlighted this by saying *"much of the advertising is aimed at trying to convince passengers or freight agents that the product they offer can be differentiated from that of their competitors because of the friendliness of the hostesses or the culinary expertise of their chefs, or because of other claims which are dubious and difficult to assess"*.

2.1 Regulation of Air Transportation

Authorities in different countries have in the past accepted that states have sovereign rights in the air space above their territory, so direct government intervention in air transport resulted. Air space became a country's valuable natural resource. Through this intervention the governments formulated Aviation Acts to regulate the number of airlines operating in a particular market. By so doing the government controls entry through a requirement in the Act that stipulates that every air carrier needs to obtain a certificate from the authorities to venture into air transportation over stipulated routes. Exit is also controlled in that authorities must approve the dropping of a route by an airline (O'Connor, 1978).

The state regulation in the airline service was usually attributed to the fear that too many airlines in the more lucrative markets might result in wasteful duplication, overcapacity, too many empty seats and higher rather than lower costs. Rate wars may also result in newcomers in a market trying to undercut the existing rates in a bid to become established, but only leading to the incumbent carriers cutting their rates even lower. This process might continue to the detriment of a stable, safe and reliable air service. Another reason for government intervention is related to the "cream-skimming" operators. This is whereby an airline jumps into the market over a holiday period when it knows it will carry full flights, and then disappear or not serve the market at times of leaner traffic (O'Connor, 1978). For South Africa this was not exactly the problem, but authorities had to take precaution to prevent it from happening.

It should also be borne in mind that regulation is a broad concept. It can also refer to the technical and safety requirements that are not specific to a particular airline but which are general to most countries and are promulgated as regulations of the civil aviation in different countries. Controls of fares, freight tariffs, frequencies and capacity are all part and parcel of the regulations.

Having said that, the significant role transport plays in the social and economic development of South Africa led to the government recognising it as one of its main priority areas for socio-economic development (Department of Transport 1996).

Table 2 shows the contribution of transportation and communication to Gross Domestic Product (GDP) over the years. As can be seen per the arrangement of the Table, this sector follows the economic business cycle. The changes are from different quarters (qtr) over the years.

Table 2

Changes in Real GDP

Average Annualised Percentage Changes in Seasonally adjusted quarterly data

Sector	Upswing	Downswing	Upswing	Downswing	Upswing
	2nd qtr 83 to 2nd qtr 84	3rd qtr 84 to 1st qtr 86	2nd qtr 86 to 1st qtr 89	2nd qtr 89 to 2nd qtr 93	3rd qtr 93 to 2nd qtr 96
Transport & Communicati on	11	-2.5	3.5	-	4

Source: SARB Annual Reports(1984-1997)

Therefore, it is apparent from the above discussion that every country would want to start by regulating its aviation business as a bid to enhance its economic prosperity.

This might involve protecting infant domestic airlines from the fully fledged foreign competitors who might only be interested in maximising profits. However, there is always the problem of the infant industries hiding behind state protection and thus staying “infant” forever. The resultant effects of these are inefficiency which leads to the reduction in the contribution of the sector to the socio-economic life of a country (negating the main objective of protection) and waste of state funds.

2.2 South African Airways-Historical background

Civil Aviation in South Africa dates back to the beginning of the 19th century when people were just curious and imaginative of how to travel between the major centres of the country within a shorter time. Others were being adventurous and wanted to take advantage of the all year favourable South African climate and fly.

However, the state became involved through the airforce in 1921. An organisation called the Civil Air Board was formed in 1921 to draft some aviation regulations. From this Union Aviation was passed by parliament in 1923, which provided legislation for the granting of aviation licences. The act also required that pilots had to fly a minimum of two hundred hours before acquiring a “B” licence, which enabled them to transport passengers.

The first main recommendation of the Board was that due to the amount of time it takes letters to reach Durban from Cape Town by train, a passenger and airmail services should be operational between the two cities by the South African Airforce (SAAF). The government was initially reluctant to go along with these proposals because of financial reasons. The board had also recommended that if the SAAF service proves satisfactory it should be taken over by a government subsidised commercial company (SAA Public Relations Division, 1986).

The government eventually approved the proposal, but only for airmail service on a trial basis. Thus in 1925 the first official flight was launched between Cape Town and Durban. The service was run for four-and half months with great technical efficiency, but the main obstacle was that the commercial results were disappointing. With no passenger revenue the expenditure was greatly in excess of the revenue earned.

Therefore, the future of the service was bleak, especially because it was estimated that a private company would need a subsidy of 25,000 pounds sterling a year to continue the service (SAA Public Relations Division, 1986)

Thus, the operation was shelved for about four years until 1929 when the government entered into a contract with Union Airways for the operation of airmail service between the main South African centres. The contract provided for a three year government subsidy of 8,000 pounds sterling a year for freighting mail. The South African government officially acquired the assets and liabilities of Union Airways and absorbed the company in the newly formed airways system (South African Airways) with a flying springbok emblem in 1934. Thus SAA started with two Gypsy Moths, a Puss Moth, three Junkers F13s and a Junkers W34, offering chartered and scheduled flights (SAA Public Relations Division, 1986)

From then on with financial backing of the Railways (cross subsidisation) the SAA grew stronger and stronger. They also acquired South West African Airways as demand for air service increased. During this period the headquarters and maintenance base were in Durban. However the increase in importance of Johannesburg as the centre of the route network led to the headquarters being moved to the Johannesburg Rand Airport.

Although SAA operations fell back in the war years of 1940 to 1944, a network of domestic services were immediately resumed and new ones opened after the wars. SAA quickly enhanced its reputation in the civil aviation world. Another important step in the history of South African aviation was in 1953 when Jan Smuts Airport was officially opened, by the then minister of transport who commented that "*safety, regularity, convenience and comfort are the key-notes of our air policy*" (SAA Public Relations Division, 1986). This was followed by opening of airports in other main centres of Cape Town, Durban and Port Elizabeth in the names of D.F Malan, Louis Botha and H.F Verwoerd Airports respectively.

2.3 Regulation of SAA

As already mentioned with regard to the reason for state intervention in the airline services, SAA was no exception from the government involvement. SAA falling under the South African Transport Services (SATs), together with Railways, Pipelines, Harbour and Road transport meant that the central government had a great influence on them. An example of state regulation of both international and domestic air services elsewhere, was shown by Doganis (1993 :46) who mentioned that “ *in the US the Civil Aeronautics Act of 1938 was introduced to regulate and control competition between US domestic carriers because the unregulated competition which had prevailed up to then had led to chaotic conditions, little security for investors and low safety margins. For many years the American view was that, while air transport is not a natural monopoly, regulation is required because unregulated competitive market forces may have adverse consequences for the public at large*”. SATs was a commercial enterprise which had to produce and sell its services under market and organisational pressure. On the other hand being a public body, it had to function as an instrument of public policy subject to direct government control of many of its activities. These twin activities often put pressure on SATs leading to conflicting decisions being made.

Thus the origin of government intervention in transportation in South Africa can be traced back to the Railway Age. Certain traffic were charged higher rates to earn sufficient revenue to cross subsidise unprofitable ones. Airline services were among those which needed cross-subsidisation as they were still emerging. Therefore, regulation was seen as an attempt to achieve a balanced, integrated and coordinated system. It could only be justified on the basis of the interest of public policy.

However, government policy always left some room for internal competition with SAA. Even though this was the case, the role of domestic airlines was mainly limited to providing feeder services, linking up with SAA's scheduled services. The Air Services Act regulated scheduled passenger air services in South Africa and elements of control included entry to the industry, data requirements when applying for a license and protection of operators offering a satisfactory service. Therefore, once an

airline had received permission to operate a service on a route, that route virtually becomes its property and no other airline may operate a service there. Airlines operated freely on routes they had sole right, which meant that they could make any decision on the frequency of flights and the fares they charge.

As a result of the regulating system, SAA maintained a dominant share in domestic services. This is illustrated by Table 3 below with SAA licensed to fly directly among the main centres in South Africa. All are direct flights from Johannesburg (JHB) to other towns of Cape Town (CPT), Port Elizabeth (PE), Durban(Dur), East London (E.L), Bloemfontein (Blm), George (Geo), Nelspruit (Nels) and Kimberly (Kim).

Table 3.

Airlines involved in the South African domestic air service as at December 1997

From JHB to							
<u>CPT</u>	<u>PE</u>	<u>Dur</u>	<u>EL</u>	<u>Blm</u>	<u>Geo</u>	<u>Nels</u>	<u>Kim</u>
1.SA Express	1SAA	1SA Express	1.SAA	1.SAA	1.SAA	1.Metari a Express	1SA Express
2.Comair	2.Sun Air	2.Comair			2.SA Express		
3.SAA		3.SAA					
4.Sun Air		4.Sun Air					
5.Nation Wide							

Table 3 reveals the presence of SAA to all the major cities in South Africa while other private airlines can only operate between a few cities. There seems to be a fair amount of competition between JHB and Cape Town (five airlines) as well as between JHB and Durban (four airlines). This could be attributed mainly to the flow of tourists to these cities. An analysis of aviation policy in South Africa is complex because it is divided into two distinct areas of domestic policy and international policy. Domestic

policies are those the government has full power to regulate such as air transport, aviation safety, airports and airspace. On the other hand international policies are those based on international air transport and relationships with international organisations and other governments. The international policy was subjected to intense political pressures throughout the 1980s as a result of protests about apartheid. According to Pirie (1992:341), the mid 1980s saw Australia and the USA revoking SAA's landing rights and forbidding airlines registered in their countries from flying to South Africa. Other carriers such as Canada, closed their offices and terminated representation in South Africa.

It was in 1990 that drastic policy changes affecting South African Transport Services (SATS) were made. It involved transforming SATS from a state corporation into a state-owned public company. This meant that like any private sector company it must turn a profit and pay tax. Thus SATS was absorbed into Transnet which consists of a group of enterprises engaged in transport, namely Spoornet, SAA, PX, Portnet and Metrorail.

For civil aviation, the above policy changes meant that the principle of open competition began to prevail. Domestic air transport was deregulated further in 1991, with the main thrust that economic decisions be left to competitive forces to resolve, the importance of safety, users interest and views specifically taken into consideration and that all operators be subject to the same rules (Department of Transport 1996).

The following points were accepted to apply as domestic air transport policy;

- SAA to operate autonomously and on a commercial basis.
- Profits on international routes not to be applied to subsidise losses on domestic routes.
- Cross subsidisation between SAA and Transnet be prevented.
- Service to government not be rendered below actual cost.
- SAA not to enjoy any privileges regarding airport facilities.
- SAA not to enjoy any privileges in terms of any legislation or any practice
- No government guarantees for loans to any airline be issued.

There is also the independent Air Service licensing Council (ASLC) which is

responsible for the licensing of domestic air service operators. According to the Department of transport (1996:31), the ASLC uses the following criteria in their licence allocation roles;

- The applicant's ability to provide a safe and reliable service.
- The applicant's adherence to the prescribed requirements for insurance.
- The requirements that 75% of the service be owned by South Africans.
- The requirements that, except with prior approval, South African aircraft are to be used in providing the air service.
- That the air service would actively and effectively be under the control and management of the applicant.

With this background the role of the Department of Transport is to police the applicant's operations with regard to safe and reliable air service, by issuing an operating certificate to a licensee every year.

On the other hand, international air freight services were also deregulated to some extent. Certain categories of air freight services can currently be allowed without any economic control and others are economically regulated (Department of Transport, 1996:33). However, the implementation or enforcement of this policy might be a headache for authorities because certain carriers could by pass the provisions of the policy and gain advantage over South African carriers resulting in a disadvantage to the country and its air carriers. World trends in air line corporation and their effects may cause South African policies to become more difficult to enforce.

It is clear from the above discussions that the government has basically commercialised SAA. Therefore, being commercialised SAA is expected to be financially self reliant and conduct its affairs in accordance with generally accepted business principles and practice. Under commercialisation objectives SAA is also expected to expand its activities and gain market share at the expense of private airlines. However, this tends to negate the government's stated intentions to diminish its direct involvement in the economy.

In conclusion there is no question that the state has played an important role in the operations of SAA. What remains is to find out whether the deregulation (less state

involvement) has led to the viability of SAA on a commercial basis and if that can open ways for privatisation. As will be discussed in the next chapter there is also a need find out whether there is still a need for the government to continue to be involved in SAA in a competitive environment because this violates one of the perfect competition market conditions of equal competition constraints and opportunities.

CHAPTER THREE

3.0 SAA's Performance Before and After Deregulation

This chapter sets out to find to what extent the government regulation of SAA had influenced the behaviour of SAA in terms of cost, efficiency, resource allocation, and profitability. As already mentioned in the previous chapters regulation can be counter-productive and defeat its own objectives. The above points will be analysed by comparing the performance of SAA during the regulation period and the post regulation period. The comparison of SAA to the existing private airlines in South Africa has not been possible due to a lack of data from the private airlines, who for competitive reasons hold such information in confidentiality.

3.1 Regulation Period

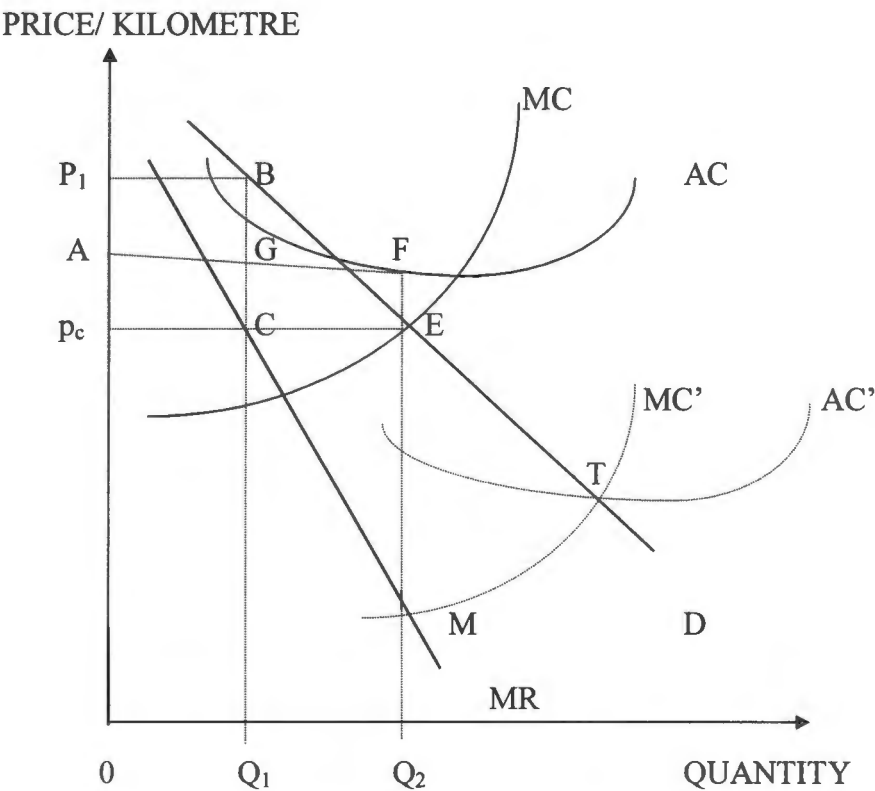
Doganis (1993), has shown that airline business is not a natural monopoly. In South Africa this can be substantiated by the existence of four small private airlines during the years of regulation. The presence of only four private airlines was due to the state's policy of allowing only a limited amount of competition in the domestic market.

The regulation policy, therefore, allowed SAA to enjoy the monopolistic profits as far as the direct flight markets were concerned, since the other four private airlines only served as feeder airlines. As a result of this, there was limited pricing freedom and product differentiation as well as limited capacity growth. The consumers were therefore, denied the benefits of lower fares, innovative pricing and greater product differentiation. Lower tariffs or competitive pricing usually has the advantage of forcing an airline to re-examine its costs and would force it to improve its efficiency and productivity. Lower costs would also facilitate further reductions in fares and as a result inefficient airlines might be forced out of a particular market (Doganis, 1993). In contrast all these were lacking in the South African domestic airline market. SAA based its pricing policy on distance rather than costs. This was mainly encouraged by

the prevalent cross-subsidisation policy, in that profit making routes were used to uplift the loss making ones.

The regulatory system in South Africa therefore, meant SAA could largely decide on the frequency of flights and the fares it charged. Fares were based on distance even though the costs of air service differed widely among markets of a given distance. The strategy followed was to set fares below cost for short distance markets and above costs for long distance markets. However, this seemed to be an inappropriate policy because, the volume of travel in a market would affect costs, but SAA continued using it. Figure 5 below (adapted from Black, Baird and Heese 1997) is used to illustrate the point.

Figure 5



Source: Adapted from Black, Baird and Heese 1997

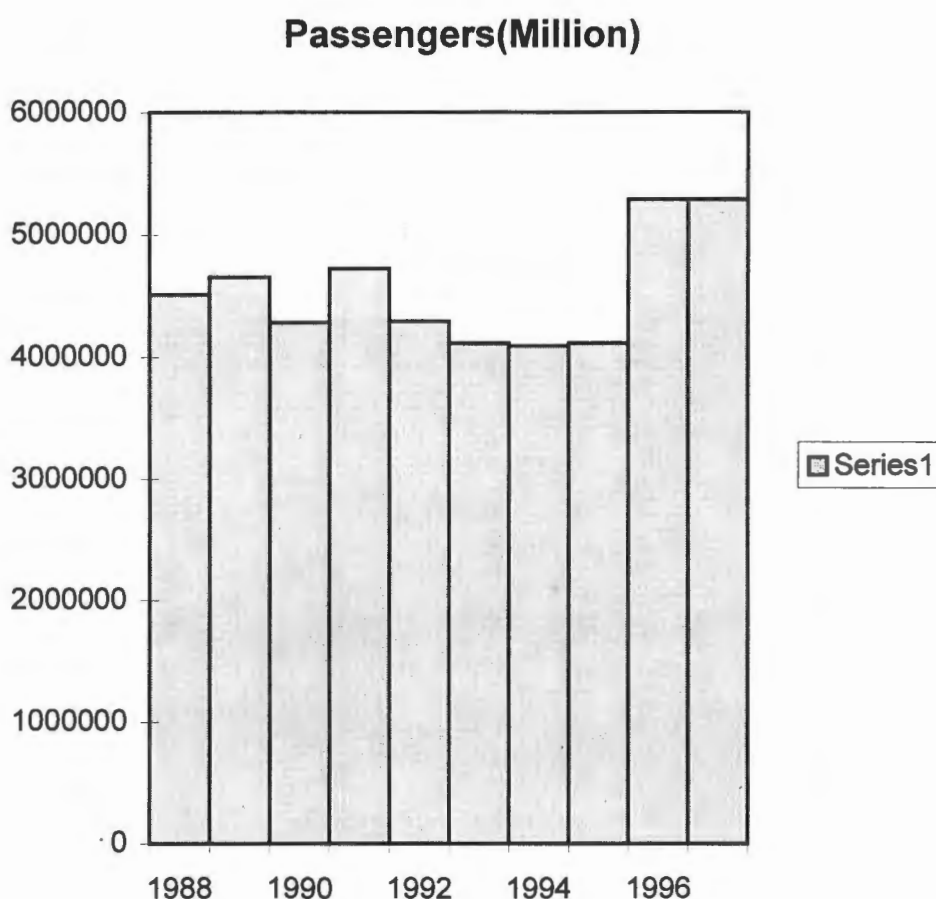
In this figure it is assumed that during regulation SAA was faced with a high cost structure as shown by AC and MC . The fare discrimination practise was to avoid making losses. Thus for long distance market a fare of OP_1 was charged for OQ_1 of the service. For the short distance market a fare of OP_c was charged for $(OQ_2 - OQ_1)$ of the

service. Total revenue was $(P_1BQ_1 + CEQ_2Q_1)$ which is larger than what could be received if there is no fare discrimination (P_eEQ_2) . This total revenue is also assumed to be larger than the total cost of AFQ_2 . Thus SAA's persistent use of this strategy was mainly because the profits made on long distance markets exceeded the losses made on the short distance market.

However, the analysis in figure 5 will be different if SAA is privatised or the market highly deregulated. Under such regimes there will be pressure for the principal -agent relations to change to the better, such as, significant cost reduction to AC' and MC' in figure 5. Thus free entry and competition would force SAA to charge a fare lying somewhere between the new monopoly fare (point M) and competition fare solution at point T. The net effect is that there will be more services provided at a much reduced fare (Black, Baird and Heese 1997:238).

Another effect of the regulatory system, was shown by SAA's dominance in domestic services against the four private airlines (Comair, Magnum Air, Namib Air and Cape Air). This dominance however was not based on the notion of the most efficient being able to command the largest market. Figure 6 shows the number of passengers carried by SAA from 1988 to 1997.

Figure 6



Source: Transnet Annual Reports (1987-1997)

It shows passengers carried falling after 1991 and staying almost constant until 1995. This fall was mainly attributed to losing some passengers to other competing airlines, especially for the domestic market while internationally, air travel was mainly hampered by the Gulf War. The increase in passengers again from 1995 could be attributed to new strategies employed by the airline to attract more passengers.

SAA's revenue mainly came from passenger business, followed by freight and airmail transportation (which it had sole rights to carry). As a result of its dominance in the market, it also meant that profits were dominated or monopolised.

As far as efficiency is concerned we have seen in our previous discussions that a firm will be allocatively efficient if it operates at a point where marginal costs are equal to price. The discussion has shown that under natural monopoly this would be

impossible as the firm's average costs will be greater than the price at that point, and thus huge losses will be incurred, leading to the nationalisation of such an enterprise. However, since SAA is an artificial monopoly (only limited competition allowed), it means it was not allocatively efficient and there is thus room for improvement. Therefore, SAA can be allocatively efficient if free entry is allowed which might lead to perfect competition and prices equal to the marginal costs being charged. From Figure 1, SAA could be currently operating somewhere between Q_m and Q_c and charging a price between P_m and P_c if not exactly at Q_m and P_m . An improvement in allocative efficiency of SAA will involve moving production more towards Q_c and charging P_c at point C in Figure 1.

3.2 Deregulation Period

On July 1, 1990, Parliament approved the deregulation of the local air transport sector. By then SAA already had a fleet of two Boeing 747-344's, six Boeing 747-244's, five Boeing 747 SP's, seventeen Boeing 737-244's and eight Airbus A300's (Annual Report, 1993). A new Boeing 747-400 was added to the fleet in 1991. *"This put SAA within the ranks of the world's fifty largest airlines"* (Annual Report, 1993:25). This is obviously a boastful comment, but it raises the question of capacity utilisation, that is, whether this fleet was really needed and to what extent they were efficiently operated. My view is that these were acquired mainly for pride and because the government provided the funds for them. The acquisition of the new B747-400 did not just involve the purchase cost, but due to its high technology (digital cockpit) it differed a lot from the other aircraft in the SAA stable. Special skills had to be acquired for its specialised maintenance as well as simulators, featuring the latest technology being purchased to assist in the training of B747-400 and A320 pilots. Therefore, it can be said that SAA supplied more flights and seats than was economically efficient.

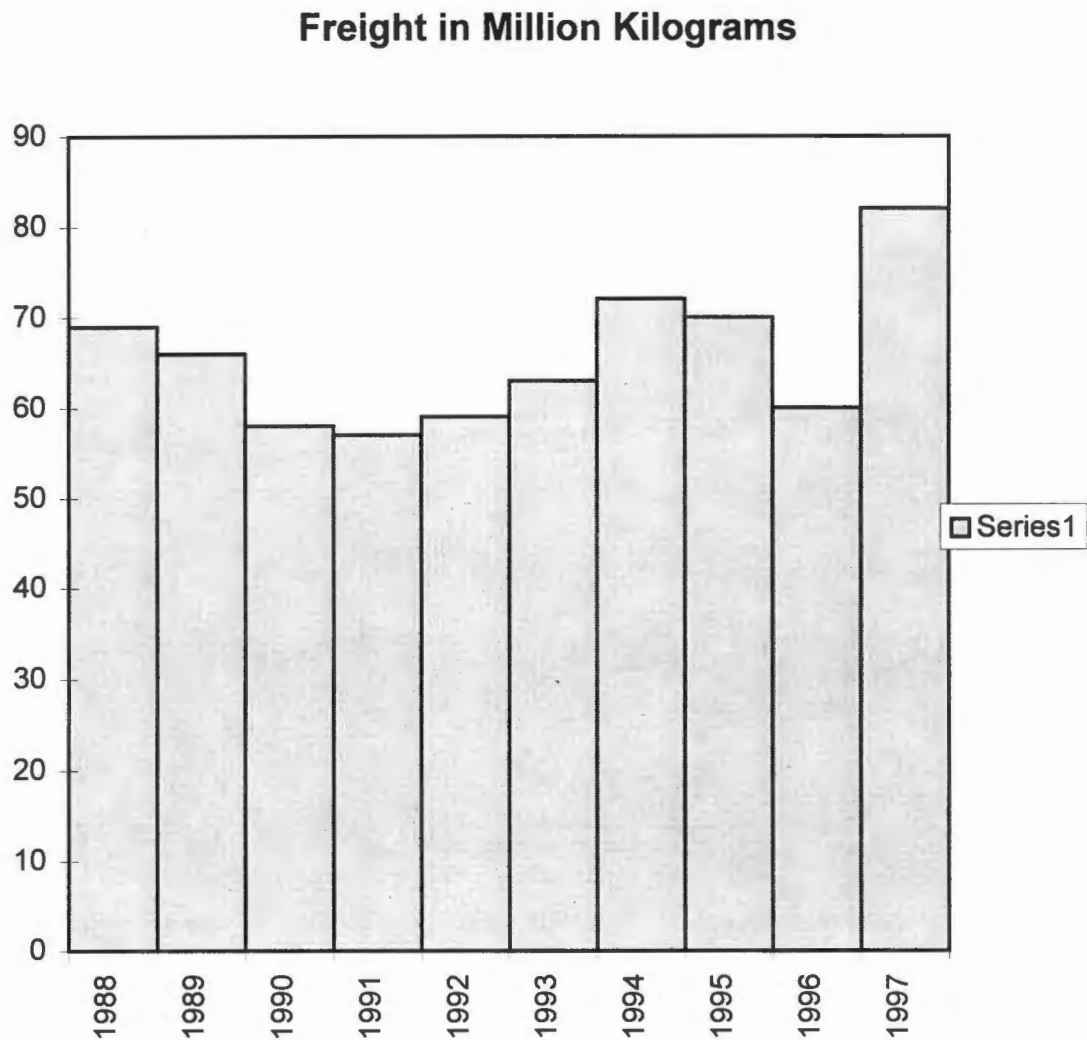
Deregulation brought some discipline in SAA as was shown by the 1992 annual report. *"....although a minor portion of SAA's operations, freight volume conveyed during the 1992 financial year rose substantially when compared to the previous year, aggressive competition and low rates resulted in this business showing a low*

yield." Annual Report 1992:25). SAA was already feeling the heat of competition in the business it used to dominate. The deregulation of the domestic air travel industry resulted in one major competitor (Flitestar) entering the market during 1992.

Although deregulation exerted pressure on air fares (a positive move for consumers, but not for SAA) renewed competition resulted in improved customer service and more frequent flights to and from the major business centres.

Figure 7 below shows how SAA's cargo dominance changed overtime. It reveals that SAA's dominance of the cargo business in absolute terms was reduced greatly after deregulation in 1990.

Figure 7



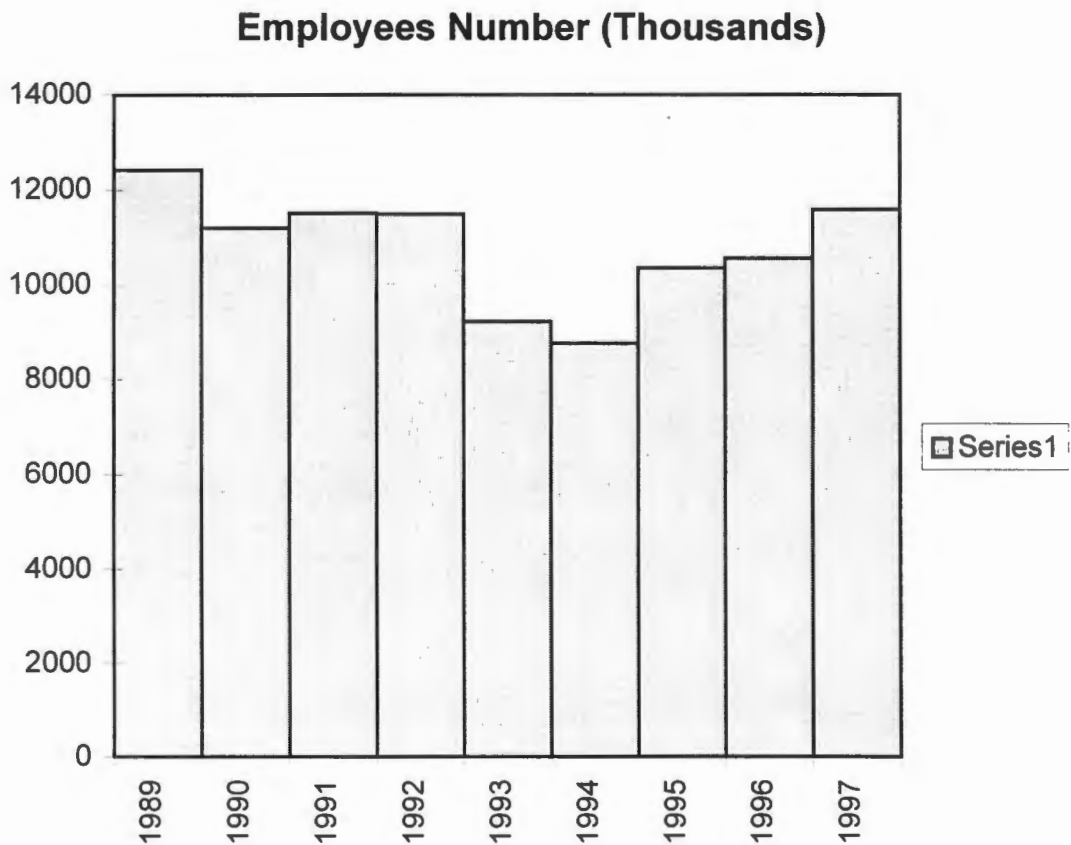
Source: Transnet Annual Reports (1987-1997)

Flitestar managed to take 25% of SAA's market share on the routes they both shared. SAA in a bid to maintain its market share introduced discounted fares (undercutting pricing) and marketed special tour packages catering to various audiences and events (Annual Report 1992). Also to reduce costs no major purchase was made during the year. According to the "Financial Mail" (October 30, 1992), there was no doubt that SAA's load factors were low. It could carry the same number of passengers with fewer aircraft, except in peak periods. This option would have allowed it to lease out its surplus aircraft. This would have been a perfect strategy for SAA to adopt in a bid to reduce its capacity by 25% (market share taken by Flitestar).

As a result of competition pressure and in a bid to stem losses, SAA embarked on a “...project success aimed at turning the airline around so as to lead to profitability in the future” (Annual Report, 1993:25). This involved closing of two overseas offices, reduced route networks through code sharing, the right sizing of staff by means of a voluntary retrenchment package and the sale of some of the older aircraft.

Figure 8 below shows how the number of employees fell from above 12000 in 1990, and kept declining until 1994. This was mainly due to the cost cutting strategy of voluntary retrenchment. However, it increased again from 1995 due to the new government’s affirmative action policies, which compelled SAA to employ more blacks without having to lay off the whites.

Figure 8



Source: Transnet Annual Reports (1987-1997)

Fares also generally decreased, or increased at a decreasing rate after deregulation as revealed by Table 4. This was mainly attributed to competition pressure rather than inflation becoming down.

Table 4.

Economy Class Fares between Cape Town and Johannesburg

Year	Average Fare	% Change
1988	189	-
1989	213	11
1990	213	-
1991	234	8.97
1992	247	5.26
1993	310	20
1994	326	5
1995	336	3
1996	395	15
1997	410	4

Fares increased at a decreasing rate from 1990 to 1992. However, in 1993 it increased by 20%. This was mainly attributed to the Competition Board's recommendations that SAA should increase its fares accordingly and stop using predatory pricing to block competition. This was as a result of the Competition Board's findings that SAA charged uneconomic prices intentionally to drive out competitors. The fares were also adjusted over the years taking into consideration the fuel prices.

Different airlines charged different fares mainly due to the availability of discounts to a relatively few passengers. This suggests that airlines were now exercising their fare flexibility to a considerable degree.

According to Graham, Kaplan and Sibley (1991), there are usually economies of scale and economies of utilisation in providing air service on a given route. The implication of this is that airlines can reduce costs by operating larger aircraft at higher load factors. However, passengers' demand for convenient service would generally require carriers to operate more frequent flights, using smaller aircraft at lower load factors,

than simple cost minimisation dictates. This has been shown by Graham et al (1991), to be especially true in short-haul markets, where surface transportation is quite competitive with air travel. Therefore, deregulation of aviation in South Africa has given SAA and other carriers the operating flexibility to choose the combination of fares, aircraft size, and load factors to maximise profit in each market.

In their paper "Efficiency and Competition in the Airline Industry" Graham et al (1991:123), show that aircraft size and load factor tend to be higher in markets where travellers place relatively little value on convenience, passengers in vacation markets for an example are generally not very time sensitive. The implication from this is therefore, that heavily travelled routes such as Johannesburg-Cape Town and Johannesburg-Durban (tourists places) would have larger aircraft and higher load factors because of diminishing returns in terms of passenger's willingness to pay for increased convenience.

Having said that, deregulation also has some other effects besides an improvement in the operation of an airline and consumers benefiting from lower fares. A study by Kim and Lichtenberg (1989), shows that deregulation in the US led to mergers of many airlines. These mergers were associated with reduction in unit cost. *"The average annual rate of unit cost growth of carriers undergoing merger was 1.1 percentage point lower, during the period of mergers, than that of carriers not involved in merger. Part of the cost reduction is attributable to merger related declines in the price of inputs, particularly labour, but about two-thirds of it is due to increased total factor productivity. One source of the productivity increase is an increase in capacity utilisation (load factor)"* (Kim and Lichtenberg 1989:1). A typical example to this effect in South Africa could be the franchise agreement between British Airways and Comair. Although one might worry about the negative effect of mergers through the reduction of consumer welfare by reducing competition and thus increasing the fare, it seems to be offset by a number of traveller benefits that mergers might provide.

Even though it might not be evident yet in South Africa, evidence elsewhere (US), has shown that deregulation has led to the growth of hub and spoke operations. This means that major airlines tend to have one or more hubs at which many of their long distance passengers change planes. The advantage of this is that, it allows carriers to fill higher proportion of the seats on their planes and to increase flight frequency of non stop routes between their hubs and other airports (Borenstein, 1992). However, a draw back to hub and spoke operation is that a larger proportion of passengers change planes, especially on longer trips, instead of flying non-stop from their origin to their destination. Changing airlines imposes substantial additional costs on passengers, due to increased probability of missed connections and lost baggage (Borenstein 1992). In the South African domestic market, a passenger does not have to change a plane unless there is no direct flight to the passenger's destination from where the passenger originates, which means that they have to fly first to where there is a direct flight.

Another benefit of deregulation in South African air travel is the increase in the choice of departure times. For example, routes between Cape Town-Johannesburg and Johannesburg-Durban are no longer thinly travelled like during the times of regulation. This is due to increased entry (more competition) into these markets.

One factor that might affect competition and efficiency in the domestic market is the airport capacity shortage. During regulation this was never a problem in South Africa, but now with increased competition, airport congestion is likely to result. For example, in a few years time Cape Town airport might not be able to handle both the domestic and international flights requiring another new airport. However, as Borenstein (1992:52), puts it, "*it is the cost of the success of airline deregulation*". Hopefully the commercialisation (or privatisation) of the airport company will be able to control this problem. One approach would be to impose congestion based landing fees, which would increase at times of peak demand.

Borenstein (1992:53), mentioned that, "*....for many economists and policy-makers,*

advocacy of airline deregulation was simply a rejection of the incredibly inefficient regulation of the previous years. On the other hand, others supported deregulation based on contestability theory, that is, they relied on the disciplining effect of potential competition". The text book theories generally conclude that actual or potential competition would drive all prices to the marginal costs of the most efficient firms, with less efficient airlines reorganising or exiting the industry. However, in reality the outcome might be a bit different. This is a warning that before one can bank on potential competition, the importance of airline networks and hub operations should be taken into account.

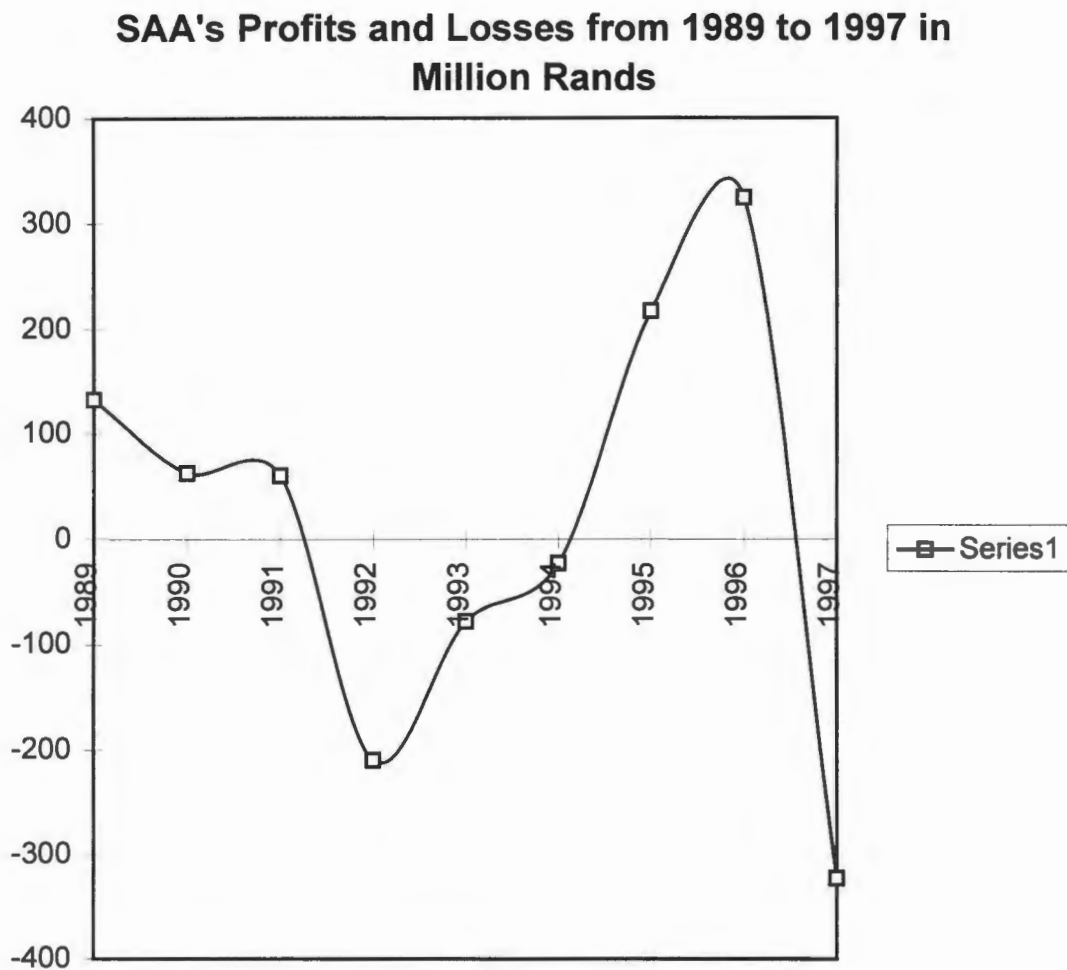
Deregulation is usually associated with price wars, as incumbent operators try to block or make newcomers' operations unprofitable. This was no exception in South African aviation. After the entry of Flitestar, it was found that SAA started practising predatory pricing to push Flitestar out. Flitestar, complained to the Competition Board that the playing fields were not yet level which made it operate in a market which persistently features residues of the monopolistic structures of the past years. The main problem was the unrealistically low fare structures practised by SAA. Another complaint was the agreement between SAA and Comair, which led to Comair leasing a Boeing 737-200 from SAA at favourable rates. This was seen by Flitestar as a collusion to oust it out of the market, since the Boeing was used on the same route Flitestar operated.

In a bid to rally behind deregulation, the Competition Board set out to investigate why SAA was not profitable. The results came in support of Flitestar's complaints, and the Competition Board recommended that SAA should raise fares by 20% and cut its flights by 30% on its three main local routes to restore it to overall profitability ("Finance Week", 1993). This strengthened the view that SAA, being a State owned enterprise, enjoyed effective subsidy from tax payer assistance and abused it by financing uneconomic fares and routes. Although the increase in fares would have negative effects to the consumers, it would only be a short term measure and they would benefit from this in the long run.

Another measure which could have been thought to hinder newcomers to gain market share is SAA's well established Frequent Flyer programme. This means that SAA would have the advantage of having secured and "trapped" customers into this programme, and thus making them inaccessible to newcomers. In fact Flitestar had already complained about this to the Competition Board before it exited the market. However, the Competition Board discontinued the investigations after Flitestar's exit from the market. Therefore, assuming that indeed marketing strategies such as the Frequent Flyer programme, corporate discounts and commissions paid to agents by SAA can hinder newcomers' market gain, then it can only be said that SAA succeeded in ousting Flitestar from the market.

The figure below shows SAA's profits over the years under consideration. It shows that it has not been consistent in its bid to make profit. Though having said that, newly restructured state owned enterprise's measures intended to restore long term viability may require large losses in the short term.

Figure 9



Source: Transnet Annual Reports (1987-1997)

In conclusion deregulation and some of the Competition Board's recommendations forced SAA to restructure its operations drastically since 1992. This was basically to rationalise markets, improve communication, competitiveness, aircraft capacity and human resource utilisation, cut costs, optimise assets, review financing costs, reorganise SAA and build international alliances. Some of these included retrenching close to 2500 employees, selling its head office building in Braamfontein, closing two foreign offices in Copenhagen and Buenos Aires and selling four Boeings 737s and a 747 kombi by the end of 1994.

Tables 5 and 6 below show some performance extracts and consolidated results of SAA respectively from the 1997 annual report. Table 5 shows that there has not been much improvement in SAA's operations. Market share has dropped in all the areas while total costs and efficiency still need to be kept under control.

Table 5

Performance Measurement

	<u>1997</u>	<u>1996</u>
<u>Efficiency</u>		
Total operating costs per revenue passenger kilometre (cents)	46,3	37,7
Personnel cost per revenue passenger kilometre (cents)	9,7	8,9
Turnover per employee (R000)	542,9	483,9
Available seat kilometre per employee (million kilometres)	2,1	1,9
<u>Effectiveness</u>		
Revenue passengers (million)	5	5
Passenger income per revenue passenger kilometre (cents)	34	31,1
Market Share: Domestic (%)	60	73
Market Share: International (%)	35	36
Market Share: Regional (%)	33	35
<u>Economy</u>		
Total operating costs per available seat (cents)	29,7	26,3
Personnel costs per available seat kilometre (cents)	6,2	6,2

Source(Transnet Annual Report, 1997)

Table 6**Results as at 31st March 1997 (Rand Million)**

	1997	1996
Internal and External turnover	5680	5013
Net (loss)/profit after finance cost	(323)	324
Total Operating Assets	5320	5175
Capital expenditure	535	918
Number of Employees	11598	10574

Source (Transnet Annual Report, 1997)

It reveals that SAA reversed the results of the previous year by almost the same amount. However, one is unable to read much from figures like this. Public corporations normally use replacement costs of capital in addition to ordinary depreciation to report their performance. Since these are charged to current income, the accounts normally show huge losses or small profits and do not reveal the actual large cash flows of the corporation. The implication here is that, if replacement costs as well as depreciation are added back to the current income, then there will be a large difference between the reported profit or loss and the cashflow generated. Therefore, cash flow analysis of SAA would give a better picture as to whether it is financially viable for privatisation.

CHAPTER FOUR

4.0 Efficiency After Deregulation

As can be seen from the discussions in the previous chapter, deregulation causes high anticipation of reduction of costs. In different ways deregulation and changing the property rights within airline firms can be expected to shift cost functions downward and permit increased output, lower final service prices and more efficient resource allocation. This chapter attempts to determine whether deregulation really had an effect on the operations of SAA.

An attempt was made to test the excess capacity of SAA using load factors. Load factor in this case is defined as the passengers carried as a percentage of the seats available for sale. The hypothesis is that SAA's capacity utilisation should have increased after deregulation given the new strategies employed such as selling some of its old aircraft and leasing out others. A regression was run using the load factor as the dependent variable and time in years as the independent variable. A dummy variable was used to show the structural break between the regulation and deregulation periods. Therefore, for regulation period 1988 to 1990 a dummy variable was generated with a value equal to zero, and from 1991 to 1997 another dummy variable equal to one was generated. Two dummies were used to see whether there was anything between the two periods that could not be explained by the model. The table below shows the result of the regression.

The model is as follows: $LOADFACTOR = \alpha_0 + \beta_1 YEAR + \beta_2 DUM + \beta_3 DUMMY$

LS LOADF C YEAR DUM DUMMY

Number of observations: 10

VARIABLE	COEFFICIENT	STD. ERROR	T-STAT.	2-TAIL SIG.
C	-956.00000	857.70025	-1.1146085	0.3077
YEAR	0.5000000	0.4312218	1.1594961	0.2903
DUM	-1820.4427	887.95308	-2.0501565	0.0862
DUMMY	0.9142857	0.4463570	2.0483284	0.0864
R-squared	0.980474	Mean of dependent var	42.10000	
Adjusted R-squared	0.970711	S.D. of dependent var	3.563394	
S.E. of regression	0.609840	Sum of squared resid	2.231427	
Log likelihood	-6.689666	F-statistic	100.4277	
Durbin-Watson stat	1.525515	Prob(F-statistic)	0.000016	

The table reveals that at 5% level of significance our dummy variable (DUM) is insignificant. This basically tells a different story from what we anticipated. It means that SAA’s capacity utilisation is still very low. The interactive dummy variable (DUMMY) is also insignificant at 5% level of significance. It supports the findings that SAA’s capacity utilisation has not yet improved even after deregulation. These findings are quite interesting given that one expects deregulation to have forced SAA to improve its capacity utilisation. This could be mainly attributed to the data used. SAA does not keep accounting records which could generally be used in statistical analysis.

On the other hand, the R^2 and the adjusted R^2 are high at 98% and 97% respectively. This means that the load factors are explained to a high degree by the relevant independent variables. The F-Statistic is significant at 5% level of significance. This basically means that the independent variables explains the variations in the load

factor (a confirmation of the R^2). The inference from this test is however that, SAA's capacity utilisation still needs to be dealt with.

Admittedly, it will not be strong enough to just conclude about the effects of airline deregulation in South Africa based on profits before and after deregulation. Since airline business depends more on the economic cycle, it is important to bear in mind that the profits are bound to be biased indicators as they would be low in periods of recessions and high in boom periods. Thus, this would have nothing to do with the effects of deregulation.

Thistle and Keeler (1990), investigated the behaviour of airline costs after deregulation. They estimated the cost function as dependant on a vector of outputs, a vector of input prices, a vector of operating characteristics, and a variable which reflects the route structure and scheduling as well as variables of the state of technology. It would have been ideal to do the same test for South Africa but as already mentioned a lack of data has constrained this. However, their findings were that there was a significant cost shift following deregulation. They also found out that the main component leading to decreased costs in both the short and long run was increased total factor productivity. This study then to some extent, supports the hypothesis that deregulation leads to reduced costs as they say, *"The effects of US deregulation on costs in the short and long run should be of interest to airline researchers and policy makers in other countries considering changes in regulation and/or privatisation of other air passenger transport industries"* (Thistle and Keeler 1990:320)

CHAPTER FIVE

5.0 Privatisation of SAA

The discussions in the previous chapter show how deregulation led to changes in aviation in South Africa. There is no question that deregulation alone is not enough. The state needs to be totally out of the operations of SAA. It would be meaningless for the state to open the market for competition and at the same time remain as one of the competitors through its involvement in SAA. The playing field should be level and this means the market forces should be allowed to prevail. Thus SAA should stop being supported by Transnet (state) and fend for itself from the capital market. SAA depends on Transnet for funds while Transnet gets the money from the government. The implication here is that since deregulation has shown what benefits can be accomplished by free market forces to consumers, the government can also benefit, or save lots of tax payers money by privatising SAA.

Although privatisation in South Africa is not a new issue (Sun Air and part of Telkom have been privatised) it is still a sensitive one. It is a sensitive issue because the labour force is still conservative about change and sceptical about the effects of privatisation. Also given the historical background of South Africa, that is, of high income inequality, high unemployment rates and the need for affirmative action, privatisation of SAA therefore, has to have some clearly set objectives. These objectives would include things such as promoting the airline service, promoting economic growth, increasing employment, reducing inequality, developing human resources, ensuring legitimacy and earning employee support¹. Privatisation then becomes complex and clashes between the authorities and the labour force becomes inevitable as trade off occurs between the above objectives and other instrumental ones such as improved corporate governance, improved efficiency, liquidity, increased investment, government budget relief, widespread shareholding and full valuation of parastatal

¹ W.J Hartnett, "Shares for All: Option for Distributing Wealth through Privatisation" Centre for Policy Studies, 1997

shares².

For SAA, as already mentioned, its efficiency has already started to improve thanks to deregulation. Now the government needs to pull out of SAA for the sake of fair competition in the airline business. The resultant efficiency gains which is attributable to improved corporate governance, in turn led to better basic service (for an example, low fares and more choice of flight time). There will also be more funds (investment) as people buy shares in SAA leading to higher economic growth. The economic growth (which is badly needed for South Africa) is closely tied to higher employment. Therefore, “ *higher employment, better basic services and widespread shareholding of privatised parastatals leads to reduced inequality. This reduction in inequality, combined with better basic services, higher employment and full valuation of privatised shares, helps to ensure the legitimacy of privatisation*” (Hartnett, 1997:11-12).

5.1 How to Privatisise SAA

There are many different ways or styles of privatisation, such as auctions, private placement, mass privatisation, management buyouts and strategic partnerships. It is also important to consider what sort of ownership will be created, such as percentage owned by foreigners and citizens. Therefore, depending on the complexity of the service that have been undertaken by the state and its objectives a broad range of methods must be employed. In this paper only strategic partnerships and management buyout will be discussed as they seem more appropriate to be used for SAA's privatisation, even though other methods might already have been used, for example, auction of Sun Air.

² W.J Hartnett, “Shares for All: Option for Distributing Wealth through Privatisation” Centre for Policy Studies, 1997

5.1.1 Strategic Partnership

Strategic partnership involves negotiations to exchange a minority stake in an enterprise for some combination of cash proceeds, capitalisation, or further commitments such as new technology or an infusion of innovative management practises. Airline business is a complex venture in terms of technology used, safety procedures and this would involve huge capital layout at the start of the business. A new competitor in a market is normally expected to break even after four years or less if they are more efficient and has lots of expertise. The advantage of this method is that only those who have the expertise in this business, or those who will be able to contribute management talent and have the ability to innovate and be in line with market changes will be considered. Being in contact with potential partners of SAA by negotiations, very crucial decisions maybe reached which could boost the prospects of SAA. For example, some might have intellectual property such as patents, software or trade secrets. Some might even have access to markets SAA only dreamed about or capital. All these are important in improving SAA's efficiency.

Strategic partnership can also advance investment. This is with the notion that it is the mechanism which motivates the investment of capital or other resources in exchange for a stake in an enterprise³. Another way of looking at this might be through confidence instilled in the business community. For example, if people had more confidence in the operations of Virgin Atlantic Airlines, and they get a stake in SAA, people will now start looking at SAA with confidence because of Virgin's reputation. This will lead to people eventually wanting to hold more shares of SAA once it is in the capital market and thus providing more funds for investment.

Another advantage of strategic partnership is that, since it involves negotiations, lots of items can be brought under negotiation, such as improvement of basic services and

³ W.J Hartnett, "Shares for All: Options for Distributing Wealth through Privatisation" Centre for

safety. Authorities would not want to get rid of SAA just for the sake of it, but it has to see to it that after that, basic services and safety are not compromised in anyway. It is also important to bear in mind that *“the implicit price of items included in strategic partnerships should not exceed the price they could be bought for on the open market”* (Hartnett, 1997:22)

The strategic partnership is also advantageous because it is more of a gradual approach as opposed to mass privatisation, where everything must be sold under legislation. The gradual approach has the advantage of the state being able to woo the support of the labour force and thus confrontations can be avoided. This alone saves the state lots of money which could be lost through clashes with the labour force. Gradualism also leaves some element of hope in all the parties concerned that the whole process might be reversed if it does not work.

From the discussions above it clearly gives foreign investors an edge over domestic investors to get a majority stake in SAA. It is normally anticipated that giving control to a foreign company would improve the value of the privatised firm. The domestic citizens who own minority stakes in the same firm can then free-ride on such improvements. However, foreign control of domestic firms may also impose costs on domestic shareholders, since the foreign majority shareholders may have objectives other than maximising the firm's value. This may be to try to obtain large private benefits of control which cannot be shared by domestic shareholders, such as having enormous market power. As an example, a foreign firm may acquire majority shares in a firm not because they believe that the firm has great potential value, but only to get early entry into that market, which would have been closed for them. In the extreme case, a foreign firm may first buy a potential future competitor just to close it down. These problems usually plough some mixed feelings in the process of privatisation as to who should have control of the firms concerned (that is, foreigners or citizens) The strategic partnership's negotiation process makes it a better choice as it offers a better chance to address these problems as the buyer may be asked to

commit to a certain level of investment.

5.1.2 Management Buyout

This method involves the management or employees of SAA purchasing minority stakes in SAA. This can be done through negotiations or legislation, for cash proceeds involving deep concessionary prices and payment terms⁴.

The drawback of this method is that, it is likely to have a negative impact on corporate governance. The issue is that, SAA might be inefficient due to underperforming management or inefficient labour practices which needs to be overhauled by an outsider. Therefore, selling to the employees would not be doing any favour to the efficiency levels in SAA. However, one might argue that, ongoing incentives such as profit sharing or performance related bonuses of SAA shares, might help motivate employees to increase the value of SAA and thus SAA remaining efficient.

Management buyout strategy also impairs liquidity in that equity stakes are “locked” in insider hands and are private deals. Outsiders would have no chance of getting stakes in SAA and thus the liquidity would remain low. This strategy also has a negative effect on investment as it sequesters away a stake on concessionary terms and thus has a generally negative effect on corporate governance and efficiency⁵.

Another weakness of this strategy is that it might not be able to improve basic services. Basically if the same employees are not efficient, there is no way they can be

⁴ W.J Hartnett, “Shares for All: Options for Distributing Wealth through Privatisation”, Centre for Policy Studies, 1997

⁵ W.J Hartnett, “Shares for All: Options for Distributing Wealth through Privatisation” Centre for

expected to improve the service they provide.

Comparing the two strategies, it can also be seen that strategic partnership is better in many ways. It can also lead to increased economic growth, that is, if stake holders inject complementary value into SAA on positive terms. As already mentioned economic growth will trickle down to increased employment and decreased inequality.

5.3 Overseas Experience

Although airline deregulation elsewhere has been mentioned before in the paper, it has been the order of the day long time back in some countries. In the United States, the Airline Deregulation Act was passed in 1978. This allowed the industry to undergo some considerable changes as competition became the base upon which developments took place. The airline industry executive were afforded more freedom, to make their own business decisions which provided them with the opportunity to be more efficient and competitive. The results of this was that a dramatic increase of about 80% in airline productivity took place. Lots of government money was saved, with previously subsidised carriers being replaced by carriers operating smaller and better suited equipment.

New carriers entered the market, and innovative fare policies were offered and competition was now based on costs and service levels. It was also found that the destructive competition argument proved to be false as fare wars were short-lived and that fears of monopoly power resulting from big carriers remaining alone in the market were unsubstantiated. Therefore, one can say that the United States' deregulatory aviation policies have exercised significant demonstration effects on

other countries. It is now left for the countries adopting the same policies to avoid the pitfalls the US might have encountered. It is however also important to bear in mind that even though the United State's aviation deregulation policies achieved a great deal of cost reductions (especially labour cost, through wage reductions), that might not be feasible in South Africa given the attitude of South African labour unions.

The privatisation of British Airways (BA) also had impressive results. The process increased profits, and services improved. Employees also benefited as they acquired shares in the company for which they work. Based on the success of BA after privatisation, Malcolm Freeman, (BA manager in South Africa) once said that "*in its parastatal days, BA was always ambitious in terms of seeking growth of traffic, fleet size, routes flown and other trappings of general aggrandisement. These days as a commercial concern, its primary objective is profitability. Now size certainly does not in itself offer guarantee of profit*" ('Finance Week', 1992:24). In 1992 the Airline Business Survey showed BA having gained 5,8% in sales, putting it sixth on the top 20 airlines sales surveyed and also becoming first when ranked in terms of highest profits ('Finance Week', 1992:3).

Based on overseas success of deregulation and the previous arguments in favour of privatisation, it is clear that deregulation of airline business in South Africa has also been successful in bringing in competition and increased consumer choice. Normally privatisation would require foundations, or competition structures to be set before it is carried out. In South African airline business, the competition structure already exists. What still remains is for the state to pull out of the operations of SAA. If the state continues to be involved in the operations of SAA, it means the free competition market conditions are impaired and thus the state involvement might eventually cause a market failure. The bottom line is that the reasons for state involvement in the operations of SAA is no longer valid.

Having said that, privatisation of SAA is a common discussion point nowadays. The

authorities seem to be satisfied with the restructuring after deregulation thus far. They want to push ahead with at least a partial privatisation of SAA. British Airways, Virgin and Lufthansa are amongst the companies who have shown some interest in SAA. One thing that might delay the process of SAA being privatised is that all stakeholders should be consulted before the privatisation process can be implemented. The labour force reaction on privatisation is usually rebellious and this usually causes the state to lose lots of money. The labour unions are fond of pulling out of negotiations and it takes time for the state to woo them back into the negotiations. There is no once off solution to this problem because the unions are usually well organised in South Africa. Negotiations thus seem to be the only way out.

CHAPTER SIX

6.0 Conclusion

The contribution of the private sector in any economy is well recognised these days. The time has passed whereby the private sector was only given a passive or minor role in the economy. The involvement of the state in the market has had detrimental effects on the economy in most cases, especially when that involvement is not justified.

Privatisation therefore, is basically trying to react to the need for the state to remove itself from the provision of some goods and services that could be efficiently provided by the private sector. The operations of the private sector is undermined by unfair competition by the state. This is when the state is doing the work or offering the services that private concerns are also doing or offering. Private enterprises are at a disadvantage when required or “forced” to compete directly with the state. This is because the state owned enterprises are not subject to the same degree of duress to achieve an acceptable rate of return on investment and do not face the same threat of bankruptcy as does the private sector. Numerous studies have shown the advantages associated with the state leaving some of the provision for goods and services to the private sector. The state does not only save funds by doing this, but society as a whole benefits in that they would have a wide variety to choose from and at competitive prices. This stems mainly from the efficiency in corporate governance associated with the private sector as opposed to public enterprises.

Studies also show that state owned enterprises responded positively to these adjustments mainly due to the creation of hard budget constraints and restrictions on credit for them, along with functioning markets, competition and bankruptcy laws (Brada, 1996). These introduced an indirect, yet effective form of corporate governance that usually lacks in the centrally planned economies.

Despite privatisation being slow in South Africa, there is still a huge scope for it. This is a route to encouraging greater foreign investment. Portfolio investors want small stakes in large quoted companies with quality assured. Venture capitalists look for high cash flow, minority stakes after privatisation, highly motivated managers and predictable governance. The Ministry of Public Enterprises regard privatisation as a process, which carries with it heavy responsibilities to the government and the people of South Africa. It must increase the number of stake holders and owners in the South African Economy, promote empowerment, enhance fair competitiveness, facilitate growth and help to achieve the basic needs of the people and the objectives of the RDP.

The deregulation of South African aviation is a huge step towards the increase in consumer welfare. The artificial monopoly in SAA which existed due to regulation of entry has ceased to exist. The advantages of this have been that, the consumers are benefiting from lower fares, better and efficient services, as well as various airlines to choose from. SAA in the past had been accused of misusing the states' funds, by charging unprofitable fares and operating unprofitable routes. Deregulation has nipped this behaviour in the bud, the result being that unprofitable routes were abandoned and pricing policies revised. The advantage of this is that a huge chunk of the government's money is now saved and can now be allocated to areas which need urgent attention in terms of development such as rural development.

The experience elsewhere remains an important guide for South African policy makers to nurture their privatisation and react against some of the difficulties encountered elsewhere. South Africa has high prospects of succeeding in its endeavour to privatise SAA if some European countries could manage to do it amid substantial inter-modal competition, such as high speed trains which attracted air passengers.

Another support for South Africa to forge ahead with privatisation of SAA comes from the US experience which involved a noticeable welfare improvement if measured by Kaldor compensation criteria. Overall losers were more than offset by those who benefited in terms of low fares, more flight choices and safety standards not being compromised. In using experience elsewhere South Africa can restrain merger activities which might lead to market dominance, especially if huge airlines are involved.

The main lesson from this paper is that SAA has put into place measures that could be expected of a profit maximising firm. There is no doubt that these measures are also consistent with the aim of improved corporate governance. The statistical regression analysis reveals that SAA still has a lot to improve on its efficiency, and this could also be one reason why it is still struggling to show consistent performance in terms of profits.

It can also be argued that the poor performance is due to the autonomy of SAA being hampered by its being a division of Transnet (which also has to report to the state). This makes SAA unable to structure its balance sheet to suit its own requirements. The commercialisation policy states that cross-subsidisation be done away with, but the way the SAA records are reported, it is impossible to determine whether this is still practised. The government is not supposed to guarantee loans for SAA under commercialisation policy, however, there is still an element of this not being fulfilled due to the continuing association of SAA and Transnet. Despite all these being constraints of SAA to take full responsibility for results required of it, it also reveals some hidden anticompetitive measures that are imposed on the market.

Although the commercialisation or deregulation of SAA has brought about changes required for a commercial concern, there are still some contentious issues relating to the state's involvement through Transnet in SAA and thus the state's competition against private airlines. Therefore, commercialisation alone is not enough. These

issues can be resolved if SAA is privatised.

Chapter One of this paper started by giving a general overview of privatisation. The privatisation process is seen as moving from a plan to a market economy. Conditions which led to the state becoming the sole or major provider of the goods and services are discussed. It is also shown why the government can no longer ignore the importance of the private sector. The economy and the society would be better off if the state only takes the provision of goods and services which only one firm can provide (natural monopoly).

Chapter two deals with the economics of the airline business. It discusses why airline business was initially regulated, which seem to be a universal practise (not only by South Africa). The chapter also discusses the historical background of aviation in South Africa. Airline business is not a natural monopoly, thus the monopolistic advantage that resulted in SAA was mainly due to the regulation system.

Chapter three, discusses the performance of SAA before and after deregulation. It is shown that the monopolistic advantage of SAA ceased to exist after deregulation. SAA changed its operation strategy in order to be competitive as competition became intense. The ultimate beneficiary is the consumer who now enjoys better service and a wide choice of airlines. Fears normally advanced for the need to regulate airline business as revealed in chapter two, were never experienced in South Africa. The price wars were never significant and were short lived. This chapter also argues that, even though SAA has been inconsistent in its financial results, the deregulation has restructured the airline to the extent that it is ready for privatisation.

Chapter four covers a test of capacity utilisation using load factors. This failed to show that capacity utilisation has improved. From this test it can only be said that a lot still needs to be done at SAA to improve its capacity utilisation

Chapter five, discusses proposals or methods that could be used to privatise SAA. The argument is that the state's presence in the operations of SAA at this point in time is unjustified. The only impact the state can have in the airline business is the erosion of the benefits already brought by deregulation. This would be due to government failure, as the state fails to level the playing field. SAA has to compete with other airlines in the market on the same footing.

Thus SAA needs to be privatised. The best way to do this is argued to be the strategic partnership method. Now it only remains to be seen how far the South African policy makers can be able to use experience of other countries to get it right in SAA's privatisation. Having said that, there has been a point which caused some concern in this research. The lack of data or the way SAA continues to keep its records leaves little or no leeway for a better quantitative analysis, especially where costs are concerned. Numerous researches on privatisation in South Africa have been done on other sectors, for example, Telkom and Escom and if the problem of records keeping at SAA is sorted out, more research is likely to come from this sector.

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